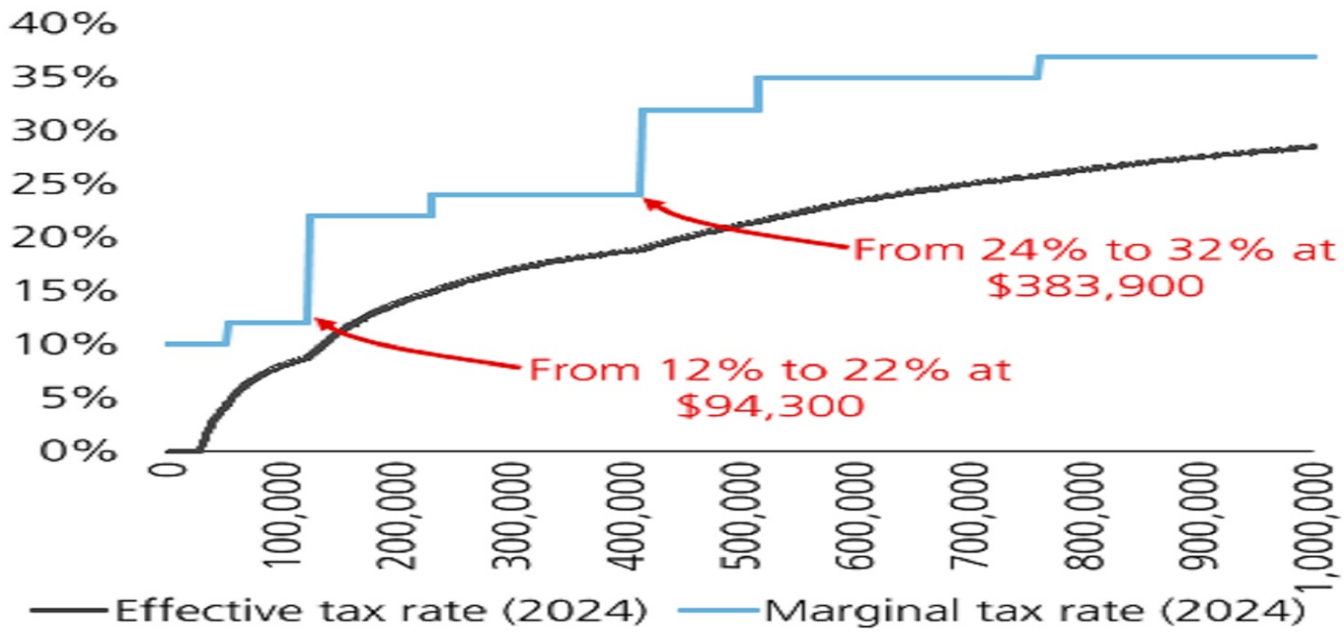

Marginal and effective tax rates for a given level of taxable income, married couple filing jointly. Higher income leads to a higher effective tax rate, never quite reaching the top marginal rate. (UBS, IRS)

What do marginal and effective tax rates mean for you?

15 April 2024, 7:37 pm EDT, written by US Editorial Team

In honor of the end of the 2023 tax season, let's take a moment to talk about the two tax rates that you should know about.

- The **marginal** tax rate is amount of tax you pay on your last dollar of income, divided by that dollar of income. As your income goes higher, your "last dollar" gets pushed into a higher tax bracket, and thus this rate goes higher.
- The **effective** tax rate is the actual percentage of taxes you pay as a percentage of all of your taxable income.

When is each tax rate relevant?

Usually, the marginal tax rate is used for making individual decisions, such as considering whether to invest in a municipal bond fund (where income is generally excluded from federal income taxes) or an investment option whose income is taxable. In such cases, we use the marginal tax rate to establish a "taxable equivalent yield" that allows us to compare both options on an apples-to-apples basis.

For example, an investor facing a 37% marginal income tax rate would consider a municipal bond with a 4% yield equivalent to a corporate bond or savings account with a 6.35% yield. The calculation would be 4% ÷ (1 – 37%) = 6.35%. Some in-state bonds are also exempt from state and local income taxation as well, which can further boost those bonds' taxable-equivalent yields (for investors facing such taxes, at least).

By contrast, effective tax rates aren't often a point of much focus. Even so, we believe that effective tax rates are worth consideration—especially when evaluating strategies to manage taxes across your lifetime. As we illustrate in our recent report, **Beyond RMDs: Strategies for IRA owners and beneficiaries**, aiming to defer income taxes as long as possible—

and trying to minimize marginal income taxes as much as possible—can often be a poor strategy for improving your after-tax growth potential. Instead, we generally recommend spreading taxable income out across as many years as possible —and thus staying in a middle-of-the-road marginal tax rate throughout your life—so that you do not end up paying a much higher tax rate in the future. In other words, families should aim to reduce their effective tax rate across their lifetime, not necessarily to minimize marginal income tax rates in a given year.

The chart above helps to illustrate the difference between the marginal and effective tax rates, and their impact on your tax obligations.

Looking at the chart, we can see that—for most families—there is a notable difference between their marginal and effective tax rates. For example:

1. If you are a married couple filing jointly and your taxable income is in the 10% marginal tax bracket (less than $23,200 of annual income), your effective tax rate will likely be negative due to the standard deduction of $29,200 per year—not to mention other benefits, such as the earned income tax credit, that could further reduce your taxable income. As a result, you may actually receive a payment from the federal government.
2. If you are a married couple filing jointly and your taxable income is $731,201 per year, your last dollar is subject to a marginal federal income tax of 37%, but your effective federal income tax rate is just 25.5%. Your annual taxable income would need to be around $1,200,000 before you reach a 30% effective tax rate.

To learn more, see the **2024 Tax fact sheet** report and talk with your financial advisor.

See the full report -**Your tax rate is probably lower than you think**, 15 April, 2024.

This analysis does not include Federal Insurance Contributions Act (FICA) taxes, state and local income taxes (which can be hefty in many cases—the top marginal tax rate is 13.3% in California), or property taxes. We also haven't accounted for tax credits and personal exemptions that could offset your taxes. In addition to these caveats, state and local taxes are generally deductible against your income for federal taxes (currently up to a "SALT cap" limit of $10,000 per year), so your all-in effective tax rate is more complicated than simply adding your state tax rate to your federal tax rate.

Consult your tax advisor concerning the tax consequences of any investment strategy that you are contemplating. Neither UBS Financial Services Inc nor any of its employees provide tax or legal advice.